Passive Activity Loss
Rules for Flow-Through Entities
Passive Activity

- A trade or business in which the taxpayer does not materially participate
- Any rental without regard to whether or not the taxpayer materially participates
- A single entity could have more than one activity
Tiered Entities

• Material participation is based on the underlying activity
• Character of income/loss and separately stated items is maintained through tiers
Economic Grouping

• Appropriate Economic Unit

• Generally, a rental activity may not be grouped with a business; Reg. 1.469-4(d)

• Once activities are grouped, regrouping in subsequent tax years is generally not permitted; Reg. 1.469-4(e)
Economic Grouping

- An S corp or partnership may group activities under the rules of Reg. 1.469-4
- A shareholder or partner may not treat activities grouped together by an S corp or partnership as separate activities
Economic Grouping

• Rev. Proc. 2010-13
• Original groupings, regroupings and additions within groupings must be disclosed for tax years starting after January 24, 2010
Material Participation

• Requires a taxpayer to be involved in the operations of the activity on a regular, continuous and substantial basis

• Generally, material participation is not applicable to rentals
Material Participation

- Seven material participation tests; Reg. 1.469-5T(a)
- The most common is participation in the activity for more than 500 hours
Partners and Shareholders

• Partnership/S corporation cannot materially participate
• Individual Partner/Shareholder must materially participate
• Passive loss limitations are applied at the 1040 level
Schedule K-1

• Box 1 has more than one business activity, an attachment to K-1 is required
• Rental activities must be separately stated on K-1 in Box 2 or 3
• If more than one rental activity, an attachment to K-1 is required
Schedule K-1

Activities need to be separated because:

• Material participation tests are applied separately by activity;

• The section 1231 rules are applied for each activity;

• Disposition of an interest applies by activity
Net Investment Income

• Existing principles in section 469 are relied upon in defining net investment income; IRC 1411

• Opportunity for activity “fresh start” regrouping
## Hot Spots on IRS.gov

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